Federal Accounting Standards Advisory Board

September 15, 2006

Memorandum

To: Members of the Board

From: Eileen W. Parlow, Assistant Director

Through: Wendy M. Comes, Executive Director

Subj: Fiduciary Activities- **Tab A**[1]

Meeting objective: To update the Board on activities relating to the status of SFFAS 31.

Staff has met with representatives from the Office of Management and Budget (OMB), the Department of the Interior (DOI), the DOI Office of Inspector General (OIG), and the DOI's independent auditing firm, KPMG LLP.

Staff has also drafted potential guidance in a Q&A format (attachment 1). Staff is not recommending a specific approach to issuance of guidance at this time. The DOI has yet to complete its assessment of the questions and answers. Therefore, staff is uncertain about the final scope of the guidance and its eventual usefulness in addressing DOI cost-benefit concerns.

The DOI has not provided staff with an estimate of the cost of a high-level estimate for accruals for the Indian Trust Funds disclosure. However, they have provided an estimated cost for a transaction-based accrual (attachment 2) in response to our November 2005 request.

Staff has also prepared a literature review of trust accounting in the private sector, including banks, not-for-profit organizations, pension trust funds and state and local governments (attachment 3). Some of this material has been provided to the Board at previous Board meetings.

[1] The staff prepares Board meeting materials to facilitate discussion of issues at the Board meeting. This material is presented for discussion purposes only; it is not intended to reflect authoritative views of the FASAB or its staff. Official positions of the FASAB are determined only after extensive due process and deliberations.

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Attachments:

1. Draft Q&A Guidance
2. Letter from DOI dated August 30, 2006
3. Literature Review for Trust Accounting in Private Sector and Other Domains

Attachment 1: Draft Q&As

Accounting for Fiduciary Activities – Questions and Answers

Q1. **Do the requirements of SFFAS 31 extend to all reports required by law or administrative action?**

No. SFFAS 31, par. 8, explains the scope of the standards as follows:

> [8] This statement provides financial reporting standards for fiduciary activities in the general purpose financial statements for Federal entities. The standard does not affect reporting in the *Budget of the United States* or special-purpose reports.

Accordingly, SFFAS 31 does not apply to (a) reports such as stand-alone audited financial statements that are prepared under an "other comprehensive basis of accounting" (which may be considered "special purpose reports") or (b) individual statements provided to beneficiaries.

Q2. May component entities aggregate fiduciary activities for disclosure purposes?

Yes. Further, discretion is permitted in selecting activities to be presented individually.

Paragraphs 20 and 21 of SFFAS 31 provide:

> [20] For component entities with several distinct fiduciary activities, summary financial information required in paragraph 18 should be provided for each fiduciary activity presented individually. Information for fiduciary activities not presented individually (see paragraph 21) may be aggregated.
>
> [21] Selecting fiduciary activities to be presented individually requires judgment. The preparer should consider both quantitative and qualitative criteria. Acceptable criteria include but are not limited to: quantitative factors such as the percentage of the reporting entity's fiduciary net assets or inflows; and qualitative factors such as whether a fiduciary activity is of immediate concern to beneficiaries, whether it is politically sensitive or controversial, whether it is accumulating large balances, or whether the information provided in the fiduciary note disclosure would be the primary source of financial information for the public.

Paragraph 20 of SFFAS 31 identifies the summary financial information that should be provided for each fiduciary activity presented individually and explains that this financial information should be presented as aggregated for all activities not presented individually. Paragraph 21 of SFFAS 31 recognizes that judgment should be exercised in deciding if any fiduciary activities should be presented individually. For example, subject to the considerations in paragraphs 20 and 21, an entity might present summary financial information for:

- all fiduciary activities in aggregate,
- fiduciary activities aggregated by type of activity such as leasing or investing activity,
- classes[2] of beneficiaries separately as individual fiduciary activities, or
- fiduciary activities conducted by individual program offices.

For example, a department has three program offices. Program Office (Office) A manages beneficiary accounts and investments for two classes of beneficiaries. Office B manages beneficiaries' rental properties for three classes of beneficiaries. Income on rental properties is transferred to Office A for Class 1 and Class 2 beneficiaries upon receipt and to Office C for the Class 3 beneficiaries. Office C manages beneficiary accounts for Class 3 beneficiaries including managing investments on behalf of the beneficiaries.

The entity may present simply "total fiduciary funds" as a single column.

Alternatively, the entity may present the information by program office to facilitate performance measurement.

Fiduciary Net Assets

As of September 30, 2009

	Office A	Office B	Office C	Total Fiduciary Funds
FIDUCIARY ASSETS				
Cash and cash equivalents	$ 566,800	$ 932,000	$ 821,454	$2,320,254
Investments	1,300,000		1,977,746	3,277,746
Interest Receivable	1,000		500	1,500
Accounts Receivable		400	500	900
Less: Accounts Payable	(200)		(200)	(400)
TOTAL FIDUCIARY NET ASSETS	$ 1,867,600	$ 932,400	$ 2,800,000	$5,600,000

[2] Beneficiaries may belong to a class if they are (1) served by the same system or program office, (2) share certain traits or characteristics (e.g., local governments), or (3) both.

Another option is to present information by class of beneficiary.

Fiduciary Net Assets

As of September 30, 2009

	Class 1	Class 2	Class 3	Total Fiduciary Funds
FIDUCIARY ASSETS				
Cash and cash equivalents	$ 649,400	$ 749,400	$ 921,454	$2,320,254
Investments	1,000,000	300,000	1,977,746	3,277,746
Interest Receivable	500	500	500	1,500
Accounts Receivable	200	200	500	900
Less: Accounts Payable	(100)	(100)	(200)	(400)
TOTAL FIDUCIARY NET ASSETS	$ 1,650,000	$ 1,050,000	$ 2,900,000	$5,600,000

Q3. In some cases several bureaus within an agency or department perform activities that result in fiduciary balances that are distributed by another bureau of the agency. Should each bureau include fiduciary activities disclosures in its stand alone audited financial statements?

If the activity meets the definition of fiduciary activity it should be reported as such.

Collections for non-Federal individuals or entities that are directly invested on behalf of the non-Federal parties or directly deposited into a non-Federal account such as a commercial bank account or a deposit fund, generally meet the definition of fiduciary and should be reported in a fiduciary note disclosure by the bureau.

In contrast, collections that are transferred to another Federal agency, component or bureau generally meet the definition of custodial activity rather than fiduciary activities. For example, the Internal Revenue Service, which is a bureau pf the Department of the Treasury, collects taxes on behalf of the Federal government and reports the collections in a Statement of Custodial Activity.

Paragraphs 61 and 101 of SFFAC 2 provide the following guidance for custodial activities:

> [61] The collection of the major sources of funds for the appropriations, e.g., taxes, royalty payments, and fines, is the responsibility of just a few reporting entities, especially the Internal Revenue Service, the Customs Service, and the Minerals Management Service. These entities are functioning in a custodial capacity and are required to turn the taxes or other monies they collect over to the Treasury or other organizations. The results of these entities' custodial activities could be reported in a flow statement that provides an understanding of from whom the taxes or other monies were collected and to whom they were distributed. This would be called a statement of custodial activities.

> [101] A separate statement of custodial activities would be appropriate for those entities whose primary mission is collecting taxes or other revenues, particularly sovereign revenues that are intended to finance the entire Government's operations, or at least the programs of other entities, rather than their own activities. The revenues should be characterized by those agencies as custodial revenues. The statement should display the sources and amounts of the collections of custodial revenues, any increases or decreases in amounts collectable but not collected, the disposition of the collections through transfers to other entities, the amounts retained by the collecting entity, and any increase or decrease in the amounts to be transferred.

Q4. In some cases, beneficiaries may direct third parties to make payments to a federal agency for credit to the beneficiaries' account. For example, the beneficiary may hold assets outside the trust and elect to liquidate the assets and have the proceeds deposited in the trust. At what point does this activity result in an asset that qualifies for disclosure as fiduciary activity?

The role of the federal entity must be understood in order to determine the extent of the fiduciary disclosure requirement in SFFAS 31. In some cases, there is no fiduciary or trust asset until an actual deposit is received. If, for example, the federal component entity has no collection responsibilities but merely receives funds directed to the entity by the beneficiary, there is no account receivable. Instead, the entity would become responsible for disclosing cash only after a deposit is made.

Q5. Is there any requirement to report fiduciary assets, liabilities or flows when the Federal entity does not perform any of the fiduciary activities listed in the definition, but does provide other services, such as advisory services that may lead to a contract being executed outside of the Federal government, with no further Federal role?

No. Certain activities that support beneficiaries may not lead to the creation of fiduciary or trust assets.

Per SFFAS 31, par. 10, in a fiduciary activity a Federal entity collects or receives and subsequently manages, protects, accounts for, invests, and/or disposes of cash or other assets in which non-Federal individuals or entities (or "non-Federal parties") have an ownership interest that the Federal Government must uphold.

For an activity to meet the definition of a fiduciary activity, the Federal entity has to perform one of more of the activities identified in the definition.

In the example given, if the functions are purely advisory, then there is no fiduciary activity to report.

Q6. Does SFFAS 31 require reporting the monetary value of fiduciary land held in trust?

No. SFFAS 31 requires a general description of land that is held in fiduciary trust and reporting of the total quantity of land held in fiduciary trust, as follows:

- beginning quantity,
- quantity received,
- quantity disposed of,
- net increase/decrease, and
- ending total quantity.

The reporting requirements for land held in fiduciary trust are found in paragraph 18 of SFFAS 31: (**bold added)**

[18] **A separate note to the financial statements should include the following information for individual fiduciary activities:**

(a) A description of the fiduciary relationship, e.g., the applicable legal authority, the objectives of the fiduciary activity, and a general description of the beneficial owners or class of owners.

(b) A Schedule of Fiduciary Activity displaying, for all periods presented:

- The beginning balance of net assets,
- The inflows from the fiduciary activities by category (e.g., contributions, investment earnings) and outflows by category (e.g., benefit payments, refunds, administrative expenses),
- The change in net assets, and
- The ending balance of net assets.

(c) A Schedule of Fiduciary Net Assets displaying the current and prior period ending balances of cash and any other assets by category (e.g., receivables, investments), and liabilities by category (e.g., accounts payable, refunds payable), and a variance analysis addressing significant changes from the prior period. **The disclosure for non-monetary fiduciary assets should include a description of the composition of the assets, the method(s) of valuation, and changes (if any) from prior period accounting methods.**

d) Component entities also may have non-valued fiduciary assets. Non-valued fiduciary assets are fiduciary assets for which required disclosure does not include dollar values. Non-valued fiduciary assets may include land held in trust. Component entities holding non-valued fiduciary assets should disclose them in a Schedule of Changes in Non-Valued Fiduciary Assets, which should include a description of non-valued fiduciary assets, beginning quantity,

quantity received, quantity disposed of, net increase/decrease in non-valued fiduciary assets, and ending total quantity.

Q7. How should the concept of materiality be applied to disclosures about fiduciary activities?

The Board's position on materiality is published in the Foreword to *Original Pronouncements, Volume 1*, available on the FASAB website at : http://www.fasab.gov/codifica.html

Materiality
The Board intends that all standards' application be limited to items that are material. "Materiality" has not been strictly defined in the accounting community; rather, it has been a matter of judgment on the part of preparers of financial statements and the auditors who attest to them. Presented below is the Board's position on the issue of materiality at this time.

> The accounting and reporting provisions of the Board's accounting standards need not be applied to immaterial items. The determination of whether an item is immaterial requires the exercise of considerable judgment, based on consideration of specific facts and circumstances.

Additional guidance on materiality is provided in SFFAC 2, SFFAS 1, and the American Institute of Certified Public Accountants (AICPA) Code of Professional Conduct.

SFFAC 2

[78] Some of a reporting entity's components are likely to be required by law or policy to prepare and issue financial statements in accordance with accounting standards other than those recommended by FASAB and issued by OMB and GAO,[3] e.g., accounting standards issued by the Financial Accounting Standards Board or accounting standards established by a regulatory agency. Those components should continue to issue the required reports. The reporting entities of which the components are a part can issue consolidated, consolidating, or combining statements that include the components' financial information prepared in accordance with the other accounting standards. They need to be sensitive, however, to differences resulting from applying different accounting standards that could be material to the users of the reporting entity's financial statements. If these differences are material, the standards recommended by FASAB and issued by OMB and GAO should be applied. The components would need to provide any additional disclosures recommended by FASAB and

[3] Note: After October 1999, FASAB issues standards absent an objection from the Office of Management and Budget (OMB) or the Government Accountability Office (GAO).

included in the OMB-issued standards that would not be required by the other standards.

SFFAS 1

[12] Except as otherwise noted, the accounting and reporting provisions of the accounting standards recommended in this Statement need not be applied to items that are qualitatively and quantitatively immaterial.

[13] The determination of whether an item is material depends on the degree to which omitting or misstating information about the item makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or the misstatement.

In addition, the AICPA Code of Professional Conduct, Rule 203 states **(bold added)**:

> Rule 203—Accounting Principles A member shall not (1) express an opinion or state affirmatively that the financial statements or other financial data of any entity are presented in conformity with generally accepted accounting principles or (2) state that he or she is not aware of any material modifications that should be made to such statements or data in order for them to be in conformity with generally accepted accounting principles, if such statements or data contain any departure from an accounting principle promulgated by bodies designated by Council to establish such principles **that has a material effect on the statements or data taken as a whole**. If, however, the statements or data contain such a departure and the member can demonstrate that due to unusual circumstances the financial statements or data would otherwise have been misleading, the member can comply with the rule by describing the departure, its approximate effects, if practicable, and the reasons why compliance with the principle would result in a misleading statement.

Materiality with respect to fiduciary disclosures should be based on professional judgment considering relevant qualitative and quantitative factors. Quantitative factors may include the relationship of fiduciary amounts to other appropriate information in the entity's principal financial statements including disclosures. For example, the quantitative materiality determination for each fiduciary item could be made based on the significance of those amounts to amounts recognized on the principal financial statements of the reporting entity, or on the significance of an individual item within the fiduciary amounts to all fiduciary amounts presented by the reporting entity.
In all cases, qualitative materiality aspects should be appropriately considered.

Q8. May estimating techniques be used when reporting fiduciary disclosures?

Yes, estimating techniques may be used when reporting fiduciary disclosures. If so, the fiduciary note should include disclosure of the use of estimates.

For example: the following disclosure appears in Note 2, Summary of Significant Accounting Policies for the FY 2005 and 2004 financial statements of the Individual Indian Monies Trust Funds Managed by U.S. Department of the Interior Office of the Special Trustee for American Indians:

> **(f) Use of Estimates** The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts of assets at the date of the financial statements and the reported amounts of increases and decreases in trust fund balances during the reporting period. Actual results could differ from those estimates.

Attachment 2: Letter from DOI Dated August 30, 2006

United States Department of the Interior

OFFICE OF THE SECRETARY
Washington, DC 20240

TAKE PRIDE IN AMERICA

AUG 30 2006

Wendy M. Comes, Executive Director
Federal Accounting Standards Advisory Board
Mailstop 6K17V
441 G Street, NW, Suite 6814
Washington, DC 20548

RE: FASAB Exposure Draft, *Accounting for Fiduciary Activities*

Dear Ms. Comes:

I received your letter dated November 8, 2005 regarding the Department of the Interior's (DOI) response to the exposure draft, *Accounting for Fiduciary Activities.* You requested estimated cost information regarding the impact of the proposed standard upon DOI if it were implemented relative to the Indian trust funds. The following is a cost estimate for implementing accrual accounting for the Indian Trust funds for the purpose of footnote disclosure pursuant to draft Statement of Federal Financial Accounting Standard 31, *Accounting for Fiduciary Activities:*

Information Technology	\$15 to \$25 Million
Communications Plan and Strategies/ Training/Regulations, Policies and Procedures/Staffing and Project Management Support	\$5 to \$7 Million
Annual Audit	\$1.5 to \$3.5 Million
Trust Asset Accounting Management System Enhancements	\$1.2 to \$2.3 Million
Total Estimated Implementation Costs	\$22.7 to \$37.8 Million

Ongoing costs are estimated at \$4 Million per year.

The estimated costs relate solely to efforts required to implement this standard and do not relate to efforts to remedy material weaknesses identified in current audits. Additionally, these costs are estimates that could change significantly when detailed specifications are provided to the contractors that provide trust system support. It is very important to understand that an accrual at a high level is not possible and that information at the ownership level will be necessary to provide reasonable accruals as the Office of the Special Trustee for American Indians (OST) issues two sets of

Attachment 2: Letter from DOI Dated August 30, 2006

financial statements, Tribal and Other Trust Funds and Individual Indian Monies. OST must have ownership level information in order to determine which financial statement to place the information on and whether the funds are to be paid through the government or paid directly to the beneficiary. Ownership level information will also be needed due to the extreme variables and changing bases inherent in Indian trust land resource management. In addition, the following assumptions were made as a basis for this estimate:

1. OST would implement accrual accounting for Indian fiduciary trust financial reporting in a planned approach to mitigate potential and known risks. These requirements would be in addition to the current cash accounting provided to the approximately 300,000 Indian beneficiaries at no cost.

2. The proposed project approach will require a minimum schedule of three years.

3. The project management is based on systems development life cycle methodology and other collateral needs that are estimated separately. The life cycle includes planning, development, testing, implementation, and operations and maintenance.

4. All DOI directives will be reviewed and analyzed to determine if there are additional needs for new directives, modifications, additions or deletions.

5. A strong communication plan and outreach is included for internal and external audiences, especially Indian trust beneficiaries and other government agencies who deal with these trust assets.

6. Costs are based on similar historical estimates. A detailed functional or situational requirements analysis has not been completed. Estimates are based on ranges obtained from various sources who qualified their opinions because detailed specifications cannot be determined at this time.

7. Annual audit costs will increase due to increased testing of internal controls and financial statement complexities (e.g. accounts receivable value and completeness, allowances and visibility of Indian issues).

If you have any questions, please call me at (202) 208-5225.

Sincerely,

Daniel L. Fletcher
Director, Office of Financial Management

Enclosures

Attachment 3: Literature Review for Trust Accounting in Private Sector and Other Domains

Financial Reporting and Auditing for Fiduciary Activities of Banks, Other Private Trusts, and State and Local Governments

Part 1: Banks

Summary of results:
Reporting and auditing requirements do not directly address accrual accounting for receivables.

There is indirect evidence that cash accounting for revenues is permitted, but that accrual accounting is required for liabilities of trust funds (see AICPA Audit and Accounting Guide for Depository and Lending Institutions, section 20.21).

In addition, the oversight responsibility for audits of fiduciary activities of banks must be assigned to a "fiduciary audit committee" that must consist of individual who are not involved in the administration or management of the fiduciary activities.

Reporting Requirements

General purpose external financial reports do not include information about assets held in a fiduciary capacity. Thus, generally accepted accounting principles (GAAP) for depository institutions exclude fiduciary assets.

AICPA Audit and Accounting Guide for Depository and Lending Institution:

> [20.16] While a trust department or trust company may have responsibility for the custody of trust assets, they are not assets of the institution and, therefore, should not be included in the institution's financial statements. However, cash accounts of individual trusts are often deposited with the institution in demand and time deposit accounts, and revenues and expenses related to fees for trust activities are recognized in the institution's income. Trust department income should be presented on the accrual basis. Financial institutions often make financial statement disclosures describing the nature of the trust activities and are required to apply the provisions of Financial Accounting Standards Board (FASB) Statement on Financial Accounting Standards No. 5, *Accounting for Contingencies,* to any contingencies that may exist related to trust activities.

Regulatory reporting requirements for the fiduciary activities of banks are published in Title 12, Code of Federal Regulations (CFR), Chapter 1, *Office of the Comptroller of the*

Attachment 3: Literature Review for Trust Accounting in Private Sector and Other Domains

Currency, Part 9 and Chapter 5, *Office of Thrift Supervision,* Part 550, and the AICPA Audit and Accounting Guide for Depository and Lending Institutions (**bold added)**:

12 CFR, Chapter 1, Part 9:

§9.8 Recordkeeping

(a) *Documentation of accounts*. A national bank shall adequately document the establishment of each fiduciary account and **shall maintain adequate records for all fiduciary accounts.**

12 CFR, Section 550:

Recordkeeping Requirements

§550.410 What records must I keep?

You must keep adequate records for all fiduciary accounts. For example, you must keep documents on the establishment and termination of each fiduciary account.

§550.420 How long must I keep these records?

You must keep fiduciary records for three years after the termination of the account or the termination of any litigation relating to the account, whichever is later.

§550.430 Must I keep fiduciary records separate and distinct from other records?

You must keep fiduciary records separate and distinct from your other records.

The Federal Financial Institutions Examination Council (FFIEC) is a formal interagency body empowered to prescribe uniform principles, standards, and report forms for the federal examination of financial institutions by the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS) and to make recommendations to promote uniformity in the supervision of financial institutions. FFIEC 031 provides a form for Consolidated Reports of Condition and Income for a Bank with Domestic and Foreign Offices. Instructions for the form include the following general provisions for reporting on fiduciary assets:

Attachment 3: Literature Review for Trust Accounting in Private Sector and Other Domains

Fiduciary and Related Assets

Institutions should generally report fiduciary and related assets using their market value as of the report date. While market value quotations are readily available for marketable securities, many financial and physical assets held in fiduciary accounts are not widely traded or easily valued. If the methodology for determining market values is not set or governed by applicable law (including the terms of the prevailing fiduciary agreement), the institution may use any reasonable method to establish values for fiduciary and related assets for purposes of reporting on this schedule. Reasonable methods include appraised values, book values, or reliable estimates. Valuation methods should be consistent from reporting period to reporting period. This "reasonable method" approach to reporting market values applies both to financial assets that are not marketable and to physical assets. Common physical assets held in fiduciary accounts include real estate, equipment, collectibles, and household goods.

As you can see, a variety of valuation methods are permitted and the guidance does not address separate treatment of receivables. An example report is provided below.

CERT #

CHARTER # COUNTY: FIDUCIARY AND R

	03/31/2006		
TOTAL FIDUCIARY AND REL ASSETS	($000)	%TOTAL	%MGD
PERSONAL TRUST AND AGENCY	61,304,923	46.57	89.47
EMPLOYEE BENEFIT DC	7,922,822	6.02	3.55
EMPLOYEE BENEFIT DB	10,215,456	7.76	5.69
OTHER RETIREMENT	3,418,615	2.60	68.34
CORPORATE TRUST AND AGENCY	1,020,253	0.78	99.96
INVESTMENT MANAGEMENT AGENCY	47,762,544	36.28	100.00
OTHER FIDUCIARY	19	0.00	0.00
TOTAL FIDUCIARY ASSETS	131,644,632	100.00	81.15
CUSTODY AND SAFEKEEPING	25,615,530		
MEMO: ACCTS IN FOREIGN OFFICES	1,833,969		0.79
TOTAL FIDUCIARY AND REL ACCOUNTS	(#)	%TOTAL	%MGD
PERSONAL TRUST AND AGENCY	45,278	65.06	94.91
EMPLOYEE BENEFIT DC	266	0.38	26.69
EMPLOYEE BENEFIT DB	129	0.19	54.26
OTHER RETIREMENT	3,991	5.73	92.51
CORPORATE TRUST AND AGENCY	33	0.05	93.94
INVESTMENT MANAGEMENT AGENCY	19,899	28.59	100.00
OTHER FIDUCIARY	3	0.00	0.00
TOTAL NUMBER OF ACCOUNTS	69,599	100.00	95.89
CUSTODY AND SAFEKEEPING	4,078		
MEMO: ACCTS IN FOREIGN OFFICES	1,255		33.23
CORPORATE TRUST AND AGENCY	($000)	#ISS	%CHG
CORPORATE AND MUNI TRUSTEESHIPS	N/A	N/A	N/A
ALL OTHER CORPORATE		N/A	N/A

Attachment 3: Literature Review for Trust Accounting in Private Sector and Other Domains

Audit Requirements

Audit requirements for the fiduciary activities of banks are published in Title 12, Parts 9 and 550 of the CFR. The AICPA Audit and Accounting Guide for Depository and Lending Institutions establishes guidance regarding financial statement audits and other engagements (such as attest engagements related to internal controls over trust operations).

CFR, Title 12, Chapter 1, Part 9 (bold added):

§9.6, Review of fiduciary accounts]
(a) *Pre-acceptance review.* Before accepting a fiduciary account, a national bank shall review the prospective account to determine whether it can properly administer the account.
(b) *Initial post-acceptance review.* Upon the acceptance of a fiduciary account for which a national bank has investment discretion, the bank shall conduct a prompt review of all assets of the account to evaluate whether they are appropriate to the account.
(c) *Annual review.* At least once during every calendar year, a bank shall conduct a review of all assets of each fiduciary account for which the bank has investment discretion to evaluate whether they are appropriate, individually and collectively, for the account.

§9.9, Audit of fiduciary accounts]
(a) *Annual audit*. At least once during each calendar year, a national bank shall arrange for a suitable audit (by internal or external auditors) of all significant fiduciary activities, **under the direction of its fiduciary audit committee**, unless the bank adopts a continuous audit system in accordance with paragraph (b) of this section. The bank shall note the results of the audit (including significant actions taken as a result of the audit) in the minutes of the board of directors.
(b) *Continuous audit.* In lieu of performing annual audits under paragraph (a) of this section, a national bank may adopt a continuous audit system under which the bank arranges for a discrete audit (by internal or external auditors) of each significant fiduciary activity (*i.e.,* on an activity-by-activity basis), **under the direction of its fiduciary audit committee**, at an interval commensurate with the nature and risk of that activity. Thus, certain fiduciary activities may receive audits at intervals greater or less than one year, as appropriate. A bank that adopts a continuous audit system shall note the results of all discrete audits performed since the last audit report (including significant actions taken as a result of the audits) in the minutes of the board of directors at least once during each calendar year.
(c) ***Fiduciary audit committee.*** **A national bank's fiduciary audit committee must consist of a committee of the bank's directors or an audit committee of an affiliate of the bank. However, in either case, the committee:**

(1) Must not include any officers of the bank or an affiliate who participate significantly in the administration of the bank's fiduciary activities; and

(2) Must consist of a majority of members who are not also members of any committee to which the board of directors has delegated powers to manage and control the fiduciary activities of the bank.

12 CFR, Chapter 5, Part 550:

Audit Requirements

§550.440 When do I have to audit my fiduciary activities?

(a) *Annual Audit.* If you do not use a continuous audit system described in paragraph (b) of this section, then you must arrange for a suitable audit of all significant fiduciary activities at least once during each calendar year.

(b) *Continuous audit.* Instead of an annual audit, you may adopt a continuous audit system. Under a continuous audit system, you must arrange for a discrete audit of each significant fiduciary activity (*i.e.,* on an activity-by-activity basis) at an interval commensurate with the nature and risk of that activity. Some fiduciary activities may receive audits at intervals greater or less than one year, as appropriate.

§550.450 What standards govern the conduct of the audit?

Auditors must follow generally accepted standards for attestation engagements and other standards established by the OTS. An audit must ascertain whether your internal control policies and procedures provide reasonable assurance of three things:

(a) You are administering fiduciary activities in accordance with applicable law.

(b) You are properly safeguarding fiduciary assets.

(c) You are accurately recording transactions in appropriate accounts in a timely manner.

§550.460 Who may conduct an audit?

Internal auditors, external auditors, or other qualified persons who are responsible only to the board of directors, may conduct an audit.

§550.470 Who directs the conduct of the audit?

Your fiduciary audit committee directs the conduct of the audit. Your fiduciary audit committee may consist of a committee of your directors or an audit committee of an affiliate. There are two restrictions on who may serve on the committee:

(a) Your officers and officers of an affiliate who participate significantly in administering your fiduciary activities may not serve on the audit committee.

(b) A majority of the members of the audit committee may not serve on any committee to which the board of directors has delegated power to manage and control your fiduciary activities.

§550.480 How do I report the results of the audit?

(a) *Annual audit.* If you conduct an annual audit, you must note the results of the audit (including significant actions taken as a result of the audit) in the minutes of the board of directors.

(b) *Continuous audit.* If you adopt a continuous audit system, you must note the results of all discrete audits conducted since the last audit report (including significant actions taken as a result of the audits) in the minutes of the board of directors at least once during each calendar year.

AICPA Audit and Accounting Guide for Depository and Lending Institutions:

[20.06] Regulatory focus on the adequacy of auditing of trust operations of financial institutions has increased in recent years. The proliferation of trust charters in recent years among non-traditional bank holding companies has led the bank and savings institution regulators to more closely assess the adequacy of secondary monitoring provided by audit functions. In cases where internal audit departments do not exist or lack the expertise required to audit the complexities of financial institutions and/or trust operations, the regulators are looking often to independent auditors to supplement the existing resources. In their respective rules on audits of fiduciary activities, the OTS (12 CFR 550.440) and OCC (12 CFR 9.9) require that management arrange for a suitable audit of trust operations through the efforts of external and/or internal auditors on an annual basis or as part of a continuous audit process.

[20.07] While this is an important opportunity for independent auditors, it is one which must be carefully dealt with from a standpoint of managing expectations and attentiveness to audit and attestation standards. First, the audit requirements of the OTS and OCC are largely related to operating and compliance controls which are likely not tested in the audit of financial statements of a financial institution. Also the depth of testing of financial reporting controls will likely be greater than in a financial statement audit. Accordingly, the testing required in these areas should be the subject of separate engagements under standards for attestation engagements or consulting standards as they related to extended audit services.

Attachment 3: Literature Review for Trust Accounting in Private Sector and Other Domains

> [20.21] Accounting systems for trust departments generally use sophisticated electronic data-processing systems. The accounting records of a trust department generally should reflect the department's asset holding and liabilities to trust customers, the status of each trust account, and all transactions relating to each trust account. Records providing detailed information for each trust account generally should include the following:
>
> - Principal (corpus) control account
> - Principal cash account
> - Income cash account
> - Investment records for each asset owned, such as stocks, bonds, notes and mortgages, savings and time accounts, real property, and sundry assets
> - **Liability record for each principal trust liability**
> - Investment income

(Additional audit requirements for fiduciary activities are in Sections 20.22 through 20.29.)

Part 2: Other Private Trusts

Not-for-Profit Organizations

Not-for-profit organizations are often trustees of charitable trusts, particularly split-interest trusts, whose assets belong to third parties. The *AICPA Audit Guide: Not-for-Profit Organizations* describes a "split-interest agreement" as follows:

> Under a split-interest agreement, a donor makes an initial gift to a trust or directly to the not-for-profit organization, in which the not-for-profit organization has a beneficial interest but is not the sole beneficiary. The terms of some agreements do not allow donors to revoke their gifts; other agreements may be revocable by donor in certain situations. The time period covered by the agreement is expressed either as a specific number of years (or in perpetuity) or as the remaining life of an individual or individuals designated by the donor. The assets are invested and administered by the organization, a trustee, or a fiscal agent, and distributions are made to a beneficiary or beneficiaries during the term of the agreement. At the end of the agreement's term, the remaining assets covered by the agreement are distributed to or retained by either the not-for profit organization or another beneficiary organization.[4]

Split-interest agreements have such variable characteristics that some individual charitable trusts might closely resemble "fiduciary activities," while others might more closely resemble "earmarked funds."

In addition, there is significant uncertainty as to whether the assets and liabilities of a charitable trust should be included in the financial statements of not-for-profit organizations. The Financial Accounting Standard Board (FASB) declined to issue a standard addressing this issue when the FASB issued requirements for Transfers of Assets to a Not-for-Profit Organization or Charitable Trust That Raises or Holds Contributions for Others:

> The [FAS] Board considered whether recipient organizations that are trustees of charitable trusts should recognize an asset or a liability for trust assets but decided that this Statement should not establish standards for accounting by trustees. The Board specified two reasons for that decision. First, a recipient organization that is a trustee may not have an asset because a trustee's ability to obtain the benefits of trust assets is usually significantly limited by its fiduciary responsibilities and by the trust agreement. …Second, current financial reporting requirements for trustees that are banks differ from requirements for trustees that

[4] *AICPA Audit Guide: Not-for-Profit Organizations*, par. 6.02.

> are not-for-profit organizations, primarily in the area of whether the trustees include the assets and liabilities of trusts in their own financial statements.[5]

Regarding the basis of accounting, not-for-profit organizations are required to use the **accrual basis of accounting**.[6] However, the *AICPA Audit Guide: Not-for-Profit Organizations* noted that:

> Some not-for-profit organizations may find that financial statements prepared on the cash basis or the modified cash basis of accounting are adequate for their governing boards and other users. SAS No. 62, Special Reports (AICPA, Professional Standards, vol. 1, AU sec. 623), describes the auditor's reporting requirements when the financial statements are prepared on a comprehensive basis of accounting other than GAAP (OCBOA), including the cash receipts and disbursements basis of accounting and modifications of the cash basis having substantial support. [7]
>
> SAS No. 62 also permits an auditor to issue a special report on financial statements that have been prepared in conformity with the requirements or financial reporting provisions of a governmental regulatory agency but that do not conform with GAAP or constitute OCBOA. In that instance, the auditor's report should include a separate paragraph at the end of the report stating that the report is intended solely for the information and use of those within the entity and the regulatory agency with which the report is being filed, and is not intended to be and should not be used by anyone other than these specified parties. Such a restrictive paragraph is appropriate, even though by law or regulation the auditor's report may be made a matter of public record. The auditor may use this form of report, however, only if the financial statements and report are intended solely for filing with the regulatory agency to whose jurisdiction the organization is subject.[8]

Unit Investment Trusts

Unit investment trust are generally managed by investment companies. The reporting and audit requirements are described in the AICPA Audit and Accounting Guide for Investment Companies:

9.10 After the initial syndication by the sponsoring entity, all accounting, recordkeeping, and income and principal distribution services are performed by the trustee. The trustee distributes the accumulated income to unit holders periodically,

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[5] FASB Statement 136. par. 80.
[6] *AICPA Audit Guide: Not-for-Profit Organizations*, pars. 12.04 and 13.01-13.05.
[7] Ibid., par. 14.11
[8] Ibid., par. 14.12

usually monthly or quarterly, but sometimes semiannually or annually. Usually, as securities are redeemed or as they mature, the proceeds are distributed to unit holders. Investors may have the option of reinvesting the proceeds from income or principal distributions into additional units of the trust or other investment vehicles of the sponsor.

9.11 The trustee generally reports to unit holders periodically on the fair values of the underlying securities and on certain other financial information relating to the trust, as required by the trust agreement. The valuation policies are similar to those used by other investment companies. Audited financial statements are usually not distributed to unit holders; however, unaudited year-end distribution information is supplied by the sponsor or trustee. The trust agreement specifies the reporting of tax and other information.

Illustrative Financial Statements

9.15 The financial statements of UITs are similar to those of management investment companies. When a trust is formed, the financial statements filed with the Securities and Exchange Commission (SEC) on Form S-6 include a statement of assets and liabilities and a schedule of investments. Subsequently, if the sponsor repurchases and re-offers trust units in the secondary market, a posteffective amendment to Form S-6 must be filed periodically with the SEC. The financial statements included in the posteffective amendment, which are prepared in accordance with Regulation S-X, include a statement of assets and liabilities, a schedule of investments, statements of operations, and statements of changes in net assets (see illustrative statements in paragraphs 9.17 through 9.21). Audited financial statements are provided to prospective investors in the prospectus. Form S-6 requires that both the statement of operations and statement of changes in net assets cover a three-year period.

9.16 Certain disclosures required of registered investment companies for compliance with SEC rules and regulations are not presented in the illustrative financial statements that follow because they are not otherwise required by generally accepted accounting principles. Such compliance disclosures include—

a. The aggregate cost, for federal income tax purposes, of the portfolio of investments according to rule 12-12 (note 8) of Regulation S-X.

b. The gross unrealized appreciation or depreciation for all securities, on a tax basis, according to rule 12-12 (note 8) of Regulation S-X.

9.17

Anytown Income Trust
First Intermediate Series
Statement of Assets and Liabilities
August 31, 20X4
Trust Property

Assets	
Investment in securities, at fair value (cost $14,591,035)	
(Note 1 and Schedule 1)	$13,878,788
Interest receivable	339,174
Cash	166,489

Total assets			14,384,451
Liabilities and Net Assets			
Liabilities			
Trustee and evaluator fees payable			47
Accrued other expenses payable			475
Total liabilities			522
Net assets			
Balance applicable to 15,500 units of fractional undivided interest outstanding (Notes 1 and 3)			
Cost to original investors	15,475,560		
Less initial underwriting commission	(619,022)		
		14,856,538	
Accumulated losses	(232,610)		
Principal distributions to unit holders of proceeds from investment transactions			(239,999)
Net assets			$14,383,929
Net asset value per unit (15,500 units)			$928

The accompanying notes are an integral part of these financial statements.

Pension Plan Reporting

Employee benefit plans represent one type of trust activity. Reporting requirements established by the Employee Retirement Income Security Act of 1974 (ERISA), led to the Financial Accounting Standards Board establishing GAAP for plan reporting. Statement of Financial Accounting Standards No. 35, *Accounting and Reporting by Defined Benefit Pension Plans,* provides that the accrual basis of accounting be used. Excerpts are presented below.

Attachment 3: Literature Review for Trust Accounting in Private Sector and Other Domains

FAS 35 Summary

Standards

This Statement establishes standards of financial accounting and reporting for the annual financial statements of a defined benefit pension plan (*plan*). It applies both to plans in the private sector and to plans of state and local governmental units. It does not require the preparation, distribution, or attestation of financial statements for any plan.

The primary objective of a plan's financial statements is to provide financial information that is useful in assessing the plan's present and future ability to pay benefits when due. To accomplish that objective, the financial statements will include information regarding (a) the net assets available for benefits as of the end of the plan year, (b) the changes in net assets during the plan year, (c) the actuarial present value of accumulated plan benefits as of either the beginning or end of the plan year, and (d) the effects, if significant, of certain factors affecting the year-to-year change in the actuarial present value of accumulated plan benefits. If the date as of which the benefit information ((c) above) is presented (the *benefit information date*) is the beginning of the year, additional information is required regarding both the net assets available for benefits as of that date and the changes in net assets during the preceding year. Flexibility in the manner of presenting benefit information and changes therein (items (c) and (d) above) is permitted. Either or both of those categories of information may be presented on the face of one or more financial statements or in accompanying notes.

Information regarding net assets is to be prepared on the accrual basis of accounting. Plan investments (excluding contracts with insurance companies) are to be presented at fair value. Contracts with insurance companies are to be presented the same way as in the plan's annual report to certain governmental agencies pursuant to the Employee Retirement Income Security Act of 1974 (*ERISA*). Plans not subject to ERISA are to account for their contracts with insurance companies as though they also filed that annual report.

Basis of Accounting

87. The Discussion Memorandum referred to the following bases of accounting for the net assets of a pension plan: cash basis, accrual basis, and a modified cash or modified accrual basis. Most respondents who addressed the issue indicated a preference for the accrual basis. Some who favored either the cash basis or a modified basis cited the administrative convenience of such an approach and noted that, in many instances, the difference from the accrual basis would not be material. Respondents favoring the accrual basis generally indicated that it is the only basis that provides complete financial information relating to transactions and events occurring during the period. The Board agreed with the latter argument and believes that basis is the only one that is consistent with the primary objective.

Part 3: State and Local Governments

Accounting requirements for trusts held by state and local governments are subject to the Government Accounting Standards Board (GASB) requirements for reporting fiduciary funds

GASB 34
- Defines fiduciary funds
- Requires separate financial statements for fiduciary funds, and
- Requires the accrual basis of accounting for fiduciary funds.

GASB 34 requires that fiduciary funds "be used to report assets held in a trustee or agency capacity for others and therefore cannot be used to support the government's own programs."[9]

GASB 34 describes four categories of fiduciary funds:
1. *Pension (and other employee benefit) trust funds* should be used to report resources that are required to be held in trust for the members and beneficiaries of defined benefit plans, defined contribution plans, other postemployment benefit plans, or other employee benefit plans.
2. *Investment trust funds* should be used to report the external portion of investment pools reported by the sponsoring government, as required by Statement 31, paragraph 18.[10]
3. *Private-purpose trust funds,* such as a fund used to report escheat property,[11] should be used to report all other trust arrangements under which principal and income benefit individuals, private organizations, or other governments.
4. *Agency funds* should be used to report resources held by the reporting government in a purely custodial capacity (assets equal liabilities). Agency funds typically involve only the receipt, temporary investment, and remittance of fiduciary resources to individuals, private organizations, or other governments.[12]

GASB requires that "Financial statements of fiduciary funds should be reported using the *economic resources measurement focus* and the ***accrual basis of accounting***, except for the recognition of certain liabilities of defined benefit pension plans and certain postemployment healthcare plans."[13]

[9] GASB 34, par. 69.
[10] The "external portion" is the portion that belongs to legally separate entities that are not part of the primary government and its component units. GASB 31, par. 18
[11] Escheat property is real property for which ownership is unknown.
[12] GASB 34, pars. 70-74.
[13] Ibid., par.107 (bold added).